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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1617

CLAYTON H. SHROUT and IOLA S. SHROUT,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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PRIESMAN GRAPHICS — OMAHA, NEBRASKA

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Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit, entered in the above case on January 3, 1974, and from the denial of the Motion for Rehearing on January 29, 1974.

CITATION TO OPINION BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit entered on January 3, 1974, is printed in Appendix "A" hereto, and is not reported pursuant to court order; order denying the Motion for Rehearing is printed in Appendix "B."

JURISDICTION

The judgment of the Circuit Court of Appeals for the Eighth Cricuit was entered on January 3, 1974, and the order denying the Motion for Rehearing entered on January 29, 1974, and this appeal is taken pursuant to 28 USCA 1254.

QUESTIONS PRESENTED

1) Was Petitioner a maker or endorser or grantor of a certain promissory note within the purview of 166(f) of the 1954 IRS Code (26 USCA §166f)?

2) Does payment by note, with an additional maker, and transfer of property by way of mortgage having a cash value in excess of the note constitute payment by a cash basis taxpayer?

3) Does the decision and opinion of the Eighth Circuit Court of Appeals negate the opinion of this Court in *Helvering v. Price*, 309 U.S. 409?

4) Does a conflict exist between the opinion of this Court with the various circuits and tax court as to

what acts constitute payment and what acts constitute non-business bad debts?

STATEMENT OF CASE

This case involves a deficiency in income tax for the calendar year 1968, in the amount of $4,411.11, all of which claimed deficiency is in controversy.

The case was tried before Judge Samuel B. Sterrett, at Omaha, Nebraska, on March 16, 1971, and was submitted for adjudication upon a partial stipulation of facts, the oral testimony of two witnesses for the Petitioners, one witness for the Respondent, and documentary evidence. On April 17, 1973 Judge Sterrett entered the following DECISION:

> "ORDERED AND DECIDED: That there is a deficiency in income tax due from Petitioners for the calendar year 1968 in the amount of $4,715.62 and an addition to tax due in the amount of $1,178.91."

Petitioner, Clayton H. Shrout, who will hereinafter be referred to as husband, is an attorney whose office address is 1004 City National Bank Building, Omaha, Nebraska, who in the year 1964 represented Joseph Robert Crawford in his professional capacity as a lawyer. Husband represented Crawford "intensively" since 1958. Husband represented Crawford in a transaction with Philip R. Riley and Orville Grimes in the year 1964, involving a purchase of One Hundred Fifty Two (152) shares of stock of Col-Pac, an Illinois corporation. This transaction is evidenced by Petitioners' Exhibit 1, an agreement to sell one hundred two (102) shares of Col-Pac by Riley to Crawford. Petitioners' Exhibit 2 which is an indemnity by Riley to Crawford that Riley owned One hundred two (102) shares

of the said corporation stock free and clear of encumbrance, and Petitioners' Exhibit 3 an agreement between the City National Bank of Council Bluffs, Iowa and Crawford for a loan of $150,000 made for the purpose of purchasing the 102 shares of Col-Pac stock by Crawford. Husband testified that his signature as attorney for Crawford appears on said Exhibit 3 and that paragraph IX of said exhibit required husband to be a director of Colonial & Pacific Frigidways a subsidiary of Col-Pac. Husband testified that in addition to the Riley stock purchased by Crawford there were fifty shares of outstanding stock of the Col-Pac corporation owned by Orville Grimes which stock was ultimately purchased by Crawford. Husband testified that he represented Crawford in the purchase of the Grimes stock which purchase is evidenced by Petitioners' Exhibit 5 on which exhibit appears, inter alia, husband's signature as attorney for Crawford. For this stock Grimes was paid $21,000 and a 1962 Oldsmobile. Husband paid the $21,000 for Crawford to Grimes which sum was obtained by the procurement of a loan from the City National Bank of Council Bluffs, Iowa in that amount. Husband testified that Petitioners' Exhibit 6 indicates actual payment by him to Grimes in the amount of $21,000; and, that stipulated Exhibit F is a promissory note to the City National Bank of Council Bluffs with husband's signature as the borrower and Crawford's signature on the back thereof. Husband testified, that in this connection, neither he nor Crawford considered him a stockholder in Col-Pac because he was asked to purchase the stock by Crawford who was a business account of husband's law firm and that husband wanted to keep Crawford and his companies as an account with Crawford in control of those companies. Husband testified that at the time of the loan and the purchase of

the stock he did not think that he was going to have to pay the loan and that he did not volunteer to make the loan. Petitioners' Exhibit 8 indicates that husband considered Crawford responsible for the repayment of the loan. Husband further testified that the loan was made by him from the City National Bank of Council Bluffs on April 13, 1964 was never paid by Crawford nor any of his companies. Ultimately, because of financial difficulties, Crawford was compelled at the insistence of the City National Bank to sell Col-Pac and Colonial & Pacific Frigidways to two brothers named Digby. Husband testified that in this connection, the terms of this sale and purchase did not include the assumption of husband's note. Husband testified that payment of the obligation to the City National Bank of Council Bluffs evidenced by the promissory note dated April 13, 1964, was made on November 18, 1968, by Petitioners executing a Mortgage Note and Mortgage in the amount of $20,000 to the First National Bank of Council Bluffs, Iowa, successor to the City National Bank on Lots 3, 4, 5 and part of 6, Block 43, Townsite of Ralston, Nebraska, same being the residence of Petitioners (Petitioners' Exhibits 12 and 13). Husband testified that said property at the time of the execution of the Mortgage Note and Mortgage had a value of $40,000.

Joseph Robert Crawford testified that at the time the loan of $21,000 was made from the City National Bank of Council Bluffs for the purchase of the Grimes stock for his benefit he was the chief operator of Colonial & Pacific Frigidways, Inc. He further testified that he purchased the stock of Grimes because he wanted complete control of the Company and further that he wanted Grimes off the Company payroll because Grimes was too expensive. The

witness testified that he inquired of Dale Ball the then president of the City National Bank of Council Bluffs, if he would permit husband to borrow the money for him (Crawford) since he was loaned to the saturation point with the bank. This request was agreed to by Ball. Crawford testified that his signature appears on the back of stipulated Exhibit F, the promissory note signed by husband on April 13, 1964, because he was supposed to get the stock and the loan to husband was to enable him (Crawford) to purchase the stock from Grimes. Crawford further testified that Petitioners' Exhibit 8, a letter from husband to Crawford, correctly states the transaction involving Crawford and husband and the purchase of the Grimes stock in Col-Pac. Crawford testified that, in this connection, he considered the stock to be his and he intended to pay back the loar. The witness further testified that there were years when the fees paid by him to husband were as high as $10,000-$15,000 and years when they spent a good deal of time on his business.

Stipulated into evidence is Exhibit F which is the original note evidencing the loan of husband of Twenty One Thousand Dollars and 00/100 ($21,000) from the City National Bank for the purchase of the Grimes Stock. This note was not signed by petitioner, Iola S. Shrout, and no security was given for that note. Exhibit F contains inter alia the following language:

> "I, we, or either of us, hereby pledge to and deposit with said Bank as collateral security 50 shs Col-Pac, Inc. (Delaware) * * *, we, or either of us, promise to furnish on demand of said Bank, satisfactory additional collateral should the value of the above listed collateral depreciate * * *."

The question raised is whether or not petitioners are entitled to a deduction, as a bad debt, of Twenty Thousand and no/100 Dollars ($20,000) claimed to have been paid as indemnitor of a non-corporate obligation under Section 166 (f) of the Internal Revenue Code of 1954, Title 26 USCA.

REASONS FOR GRANTING WRIT

1) Section 166(f) 1954 Internal Revenue Code, (Section 166 Title 26 USCA) provides that a payment by the taxpayer (other than a corporation) in discharge of part or all of his obligation as a grantor, endorser, or *indemnitor* of a non-corporate obligation, the proceeds of which were used in the trade or business of the borrower, shall be treated as a debt becoming worthless within said taxable year . . . but only if the obligation of the borrower to the person to whom such payment was made was worthless at the time of such payment.

The Tax Court and the Circuit Court of Appeals considered only the form but not the substance of the transaction. Granted, from the form of the transaction it would appear that the Petitioner Clayton H. Shrout was the maker of the note; however, when all of the facts are reviewed, the substance of this transaction clearly, unequivocally and uncontradictedly shows that the Petitioner Clayton H. Shrout was not a maker, but an indemnitor. The Tax Court does recognize that the actual borrower, Crawford, was indebted to the Petitioner Clyaton H. Shrout in some way, causing the transaction to come within the purview of Section III of the IRS Code 1954.

The opinion of the Eighth Circuit confirming the Tax Court's ruling is in conflict with the opinion of the 6th Circuit in *Axelrod v. Commissioner of Internal Revenue*, No. 15043, July 17, 1963.

The factual situation in the *Axelrod* case, although not identical to this Petitioner's case, is similar in principal because therein the petitioner signed the documents, which ultimately compelled payment because of a business relationship, and therefore payment created a business bad debt.

2) The opinion of the Eighth Circuit Court of Appeals is in conflict with the opinion of this Court in *Helvering v. Price*, 309 U.S. 673. In *Helvering v. Price*, this Court said:

> "'Merely exchanged his note under which he was primarily liable for the corporation notes under which he was secondarily liable, *without any outlay of cash or property having a cash value.*'"

Because Petitioners believe that this Court was not just exercising penmanship when it wrote the above underscored words, one must conclude that the said language is also to be taken conversely. Petitioners in the instant case transferred their home, which had a cash value, to the creditor bank in payment of the note, thus making the payment deductible in the year of transference to the said bank.

CONCLUSION

For the reasons heretofore set forth, severally and collectively, Petitioners pray that this Court grant certiorari to review the opinion of the Eighth Circuit Court of Appeals.

Respectfully submitted,

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APPENDIX "A"

UNITED STATES COURT OF APPEALS
For the Eighth Circuit

No. 73-1517

Clayton H. Shrout and Iowa S. Shrout,
Appellants,
v.

Commissioner of Internal Revenue,
Appellee.

Appeal from the Decision of
the United States Tax Court

Submitted: December 12, 1973

Filed: January 3, 1974

Before BRIGHT and STEPHENSON, Circuit Judges, and STUART,
District Judge.*

PER CURIAM

Appellants appeal from a tax court decision disallowing a bad debt deduction claimed by taxpayers as guarantors of a non-corporate obligation pursuant to Section 166(f) of the *Internal Revenue Code of 1954*, 26 *U.S.C.* § 166(f).

*U.S. District Judge, Southern District of Iowa, sitting by designation.

We affirm on the basis of the well reasoned opinion of the Tax Court. 32 T.C.M. No. 398 (April 17, 1973).

We are satisfied that the findings of the Tax Court are amply supported by the record and no error of law appears. Further amplification of the Tax Court opinion would serve no useful purpose.

Affirmed.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS,
EIGHTH CIRCUIT

[not to be published]

APPENDIX "B"
UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 73-1517

September Term, 1974

Clayton H. Shrout and Iola S. Shrout,
Appellants,
vs.

Commissioner of Internal Revenue,
Appellee.

Appeal from the United States
District Court for the
Tax Court of the United States.

Petition of appellants for rehearing filed in this cause having been considered, it is now here ordered by this Court that the same be, and it is hereby, denied.

January 29, 1974

In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1617

CLAYTON H. SHROUT and IOLA S. Shrout, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The sole question raised by the petition is whether, under Section 166(f) of the Internal Revenue Code of 1954, petitioner[1] is entitled to a deduction for an alleged payment made in discharge of an obligation of a guarantor.

In April, 1964, petitioner, a lawyer, borrowed $21,000 from a local bank at the request of one of his clients for the purpose of completing a stock-purchase agreement which his client had entered into with a third party (Pet. 4; R. 51).[2] Petitioner signed and delivered to

[1] "Petitioner" refers to Clayton H. Shrout. Iola Shrout is a party to these proceedings because she filed a joint return with her husband.

[2] "R." references are to the record appendix in the court of appeals.

the bank his promissory note in this amount and made payment to the third party, who transferred the stock to petitioner (R. 37, 50-51). Petitioner pledged the stock as collateral for the loan (R. 51). The original promissory note was endorsed by the client.

In 1966, the client filed a petition in bankruptcy. Later that year, the bankruptcy court approved a trustees' report concluding that the client's estate had no assets, and granted him a discharge (R. 52).

When the original note had become due in November, 1964, petitioner executed a replacement note and has executed similar replacement notes on several occasions. In November, 1968, the tax year in issue, the bank requested additional security, and petitioner, with his wife, executed a mortgage note of $20,000 secured by a mortgage on their residence, as a partial replacement for the previous obligation (R. 52-53). On his 1968 income tax return, petitioner claimed a bad debt deduction of $20,000. On audit, the Commissioner disallowed the deduction. The Tax Court upheld the Commissioner's disallowance and the court of appeals affirmed *per curiam* (Pet. App. A 10-11).

Section 166(f) of the Code provides that a payment by a noncorporate guarantor, endorser, or indemnitor of a noncorporate obligation, the proceeds of which were used in the trade or business of the borrower, shall be treated as a deductible bad debt in the year the debt becomes worthless. This is an exception to the general rule of Section 166(d), which treats nonbusiness bad debts of noncorporate taxpayers as short-term capital losses.

Here, the Tax Court found that petitioner was not entitled to the benefits of Section 166(f) because (1)

he was primarily liable on the promissory note involved and cannot be considered the guarantor of his note; and (2) the replacement of the note with a mortgage note in the tax year did not constitute payment of the note. The express language of the promissory note pursuant to which "for value received [petitioner] promise[d] to pay to the order of [the bank]" together with petitioner's signature in its lower right-hand corner, indicates, as the Tax Court found (R. 50-51, 54), that he was the sole maker of the note and primarily liable for the obligation. As a result, petitioner was not within the class of persons entitled to a deduction as a guarantor under Section 166(f).

The alternative holding of the Tax Court that petitioner is not entitled to a Section 166(f) deduction because he had not paid the promissory note in 1968 is similarly correct. Contrary to petitioner's contention (Pet. 8), it is well established that the replacement of such a note with a secured note is not payment, but continues the obligation. Although petitioner urges a conflict with *Helvering* v. *Price*, 309 U.S. 409, that case in fact supports the decision below.[3] Relying on its earlier dicision in *Eckert* v. *Burnet*, 283 U.S. 140, the Court stated in *Price* (309 U.S. at 413):

> As the return was on the cash basis, there could be no deduction in the year 1932, unless the substitution of respondent's note in that year constituted a payment in cash or its equivalent.

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[3]Petitioner also alleges (Pet. 8) that *Axelrod* v. *Commissioner*, 320 F. 2d 327 (C.A. 6), conflicts with the decision below. That case, however, focused solely on the question whether the borrowed funds were used in the trade or business of the borrower.

> There was no cash payment and under the doctrine of the *Eckert* case the giving of taxpayer's own note was not the equivalent of cash to entitle the taxpayer to the deduction.

Nor is petitioner's position improved by the fact that the 1968 note was secured by a mortgage on his residence. The Court further stated in *Price* (309 U.S. at 413-414) as follows:

> Respondent urges that his note was secured, but the collateral was not payment. It was given to secure respondent's promise to pay, and if that promise to pay was not sufficient to warrant the deduction until the promise was made good by actual payment, the giving of security for performance did not transform the promise into the payment required to constitute a deductible loss in the taxable year. * * *

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

JULY 1974.